PCM
Peak Capital Management

4 Risks for 2020

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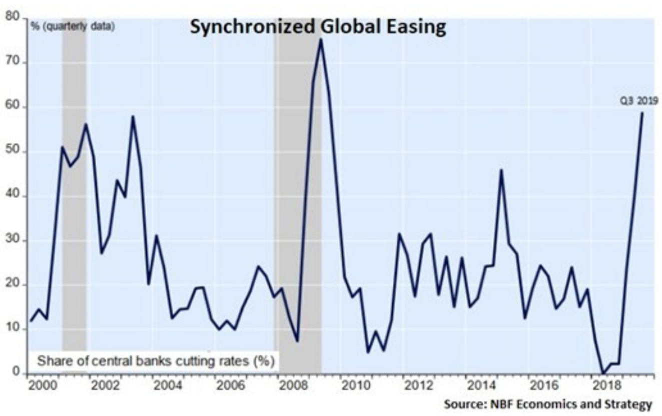
As the stock market closes 2019 with a bang, attention turns to the election year of 2020 with investors wondering if the stock market can continue the streak that has made this bull market the longest in history. It is easy to identify the headwinds at the beginning of each year; the difficult part is accurately determining if those headwinds will pose an actual threat to the rising stock market. We kick off 2020 with our risk outlook and conclude with whether the risks will make 2020 the year the bear comes out of hibernation.

RISK #1 – Political Uncertainty

I tend to subscribe to the notion that the crazier things get in Washington, DC, the less they matter. Politicians on both sides of the aisle look less like statespeople and more like B-level actors in a foreign soap opera. The markets have been correct to ignore the circus, also referred to as Congress, and that will probably be the case in 2020. No one expects any surprise in the Senate impeachment trial, assuming the Articles eventually make their way there. The bigger political risk would be if one of the socialist candidates were to make it out of the Democrat primary. Their policies might help address the growing inequality in the U.S., but would not be market friendly. The potential for a technology regulation overreach is real from those on the political left and that could spill over into other segments of the economy. Political risk may be low at this moment but is something to keep an eye on in 2020.



RISK #2 – Trade

Phase 1 of the trade deal between the U.S. and China was celebrated by the markets, and was largely responsible for the markets ending at highs in 2019. The problem is that almost no one on either side can quantify exactly what was agreed to. Halting new tariffs and a small rollback on previously implemented tariffs is certainly a positive, but very few details have emerged that both countries seem to confirm are part of an agreement. Further work needs to be done between the U.S. and China, but even if Phase 1 is simply a temporary “cease fire,” the markets will respond positively. I expect sabre rattling between the Trump administration and European leaders, especially now that the UK will leave the EU on January 31. There will be threats and retaliatory threats, but something very close to status quo should prevail in the end.

RISK #3 – U.S. Dollar Appreciation

The risks of the greenback rising to a level that threatens domestic growth is mostly overlooked today, but is the most likely culprit if the economy slumps in 2020. The dollar weakened in the last couple of months of 2019 due to the UK election results and signs that China could be near a bottom in their weak patch. There has been some positive ISM (Institute of Supply Management) readings out of Europe, but I expect growth in that region to be sub-1% in 2020 and yields remaining extremely low or negative. In a yield-starved environment I expect demand for U.S. debt to rise double-digits in 2020, driving the U.S. dollar higher. I am watching the 103 level on the DXY (September 2017 high), and as long as the dollar remains below that level market impact should be negligible.

Liquidity should win this tug-o-war, allowing markets to add to gains in 2020 even if the environment becomes more volatile.

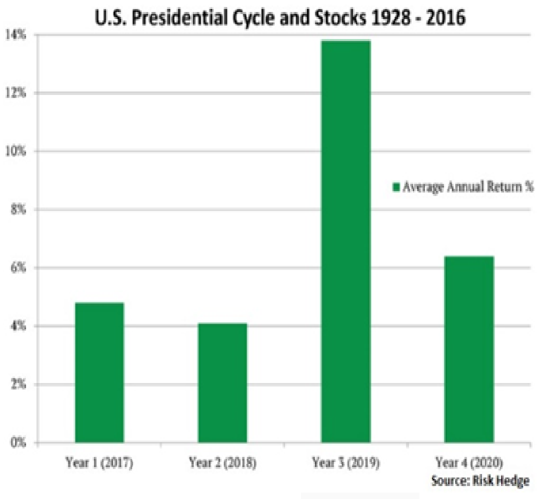
RISK #4 – Credit Scare

A disruption in the credit markets is the second most significant macro risk to the economy in my view. The spread between credit conditions for BBB and CCC paper have widened, making it difficult for lower-rated issuers. The 4th quarter also saw a deterioration in the interest coverage ratio on non-investment grade bonds. Any concern is premature today, but if the NDR Credit Conditions index, currently at 67, were to drop below 55, it would signal a reason to be concerned about the credit markets.

OUTLOOK 2020

Careful analysis of the risks posed by the above and even those not mentioned: Russia, North Korea, Iran, Repo’s, etc. suggests that while these cannot be ignored, they are unlikely to derail the bull market. The most compelling reason why is the global liquidity being provided by Central Banks. We entered 2019 with almost no Central Bank easing and enter 2020 with the most synchronized level of easing since the Great Recession in 2008; higher than the level of easing after the recession of 2000-2002. Liquidity should win this tug-o-war, allowing markets to add to gains in 2020 even if the environment becomes more volatile.

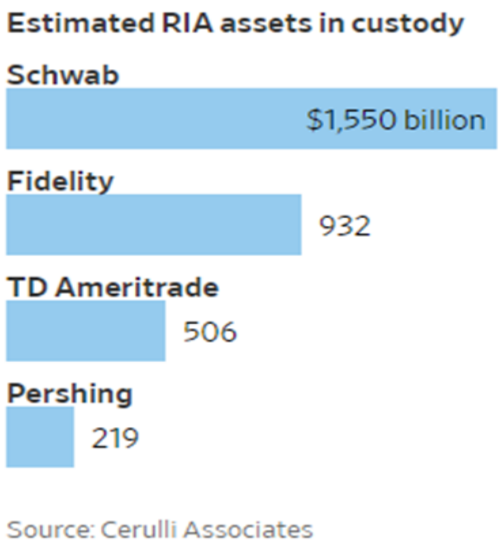
Election Year Forecasts



For investors who look to the stars or tea leaves or past cycles to forecast returns, 2019 played out as expected. The 3rd year in the Presidential Election cycle has historically been the best performing year by a wide margin. The 2nd best year in the four year cycle has typically been year 4. There is some rationale for this particular timing strategy. Presidents are elected on the promises they make that do not necessary lead to stronger economic growth. Think about healthcare and a border wall; they were promises that would not necessarily impact growth. When Presidents go back into campaign mode (many would argue Trump never left this) the focus is on the economy and jobs resulting in rising earnings and higher stock market prices.

- According to CFRA data, if the stock market is positive from July 31 to October 31 in election years, the party in the White House wins reelection. If stocks fall during that period, 86% have lost reelection.
- In 2016, the stock market fell 2.1% between July 31 and October 31, providing a signal to political watchers that Trump would win because the party in control would lose in their attempt to retain the White House.
- The Trump presidency has followed the pattern to a T so far with a strong first year, flat 2nd year (2018), and 3rd year posting the strongest gains. Time will tell on year 4.

Consolidation is King

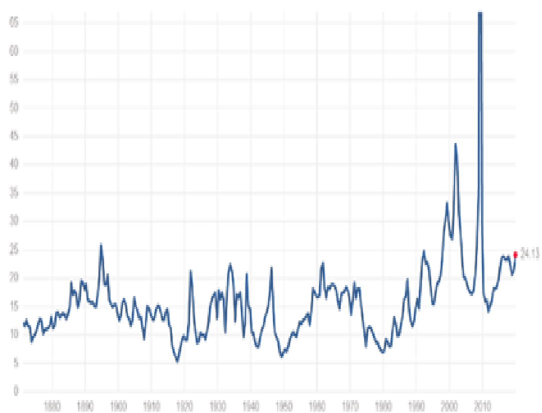


Charles Schwab made waves on Wall Street when the custodian announced that it was eliminating commissions on equity and exchange traded fund trades. The move forced TD Ameritrade, a rival custodian, to follow suit. The immediate result was that the economics for Schwab to acquire TD began to makes sense given TD's collapsing profit margins. The transaction is slated as a stock-swap valued at $26 billion. Schwab and TD locking arms results in about $2.1 trillion in investment advisor assets custodied, making up 51% of that market (Cerulli Associates). The chart below shows Fidelity trailing at $932 billion in custodial assets. While consolidation can offer economies of scale for both the advisor and their clients, service, at times, can suffer.

- Schwab serves over 7500 financial advisors, with TD Ameritrade at approximately 7000 advisors, and Fidelity servicing 3000 (Wall Street Journal).
- Custodians generate a meaningful level of revenue from interest on cash reserves.
- Further consolidation is anticipated among smaller firms such as Bank of New York Mellon (Pershing) and E*Trade Financial Corporation.
- In addition to benefiting from economies of scale among financial advisors, TD and Schwab both serve individual investors, offering potential revenue from the cash held among investors' cash holdings.

Equity Valuations and 2019 Stock Returns

S&P500 P/E Ratio



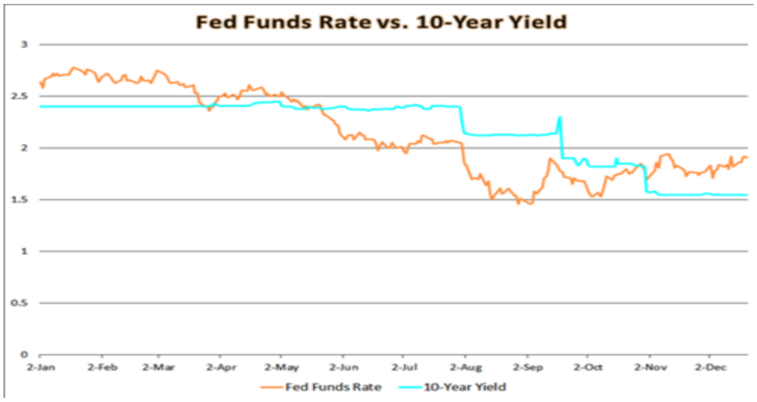
Source: Robert Shiller

While we are not in the business of predicting short-term market returns, examining current valuations in relation to longer-term averages can help us gauge if the odds for a good year are in our favor. Perhaps the most common measure of equity valuations is the price-to-earnings ratio (P/E) on the S&P 500 Index. Essentially, it measures how much an investor is willing to pay today for a stream of cash flows in the future. The table to the left plots the P/E for the S&P 500 going back over 100 years. The average P/E is roughly 15.8. Today, the P/E stands at roughly 24.3. The results in the chart are based on as-reported trailing 12-month earnings, and are provided by Roger Shiller in his book, "Irrational Exuberance."

- It would seem at first glance that with a P/E of 24.3 versus a long-term average of 15.8 we are currently overvalued. In other words, we are paying too much for earnings today, which in turn increases the probability of a pullback in near- to intermediate-term.
- We must consider the level of interest rates, however, and what other options are available to us as alternatives to stocks. Currently, the dividend yield on the S&P 500 of 1.9% is roughly the same as the yield on the 10-year Treasury. There's no overwhelming reason to rotate out of equities and into bonds.
- The lowest reading occurred in 1917, while the highest reading occurred in 2009, at the height of the Great Recession.

Macro View – A Critical Data Point

Jerome Powell has indicated that his intention is to keep rates steady in 2020. The St. Louis Fed chart below shows a very important data point — the Fed Funds Rate vs the 10 year yield. The Fed Funds rate is trending below the 10 year yield. Without stating the obvious, this reinforces sentiment of an accommodative Fed policy. The past decade has proven the benefits to the economy and market of an accommodative central bank. The chart also demonstrates low yields from treasuries, forcing investors to look to equities for greater returns and yield profiles given greater risk. The yield on the S&P 500 ETF, SPY, is 1.75% as of December 20th. A yield on equities greater than the 10 year yield will further drive investors to equities versus fixed income. This chart and the messages behind the chart certainly bode well for stock prices in 2020.



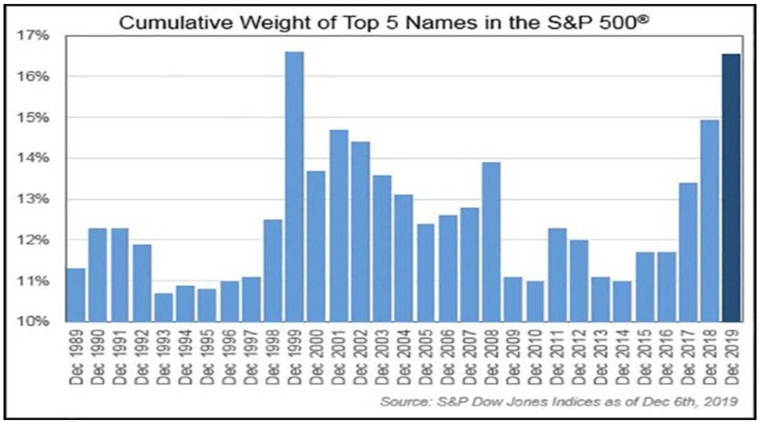
Source: St Louis Fed

Fixed Income - The Crash that Wasn't

Fixed income analysts sounded warning bells in January 2019 that the high yield bond market was on the verge of collapse. The Fed was hiking rates in the 4th quarter of 2018 while shrinking their balance sheet. Credit conditions were tight and a wave of refinancing was going to crash the market. Most experts believed there was only one direction junk bonds could move — higher yields and lower prices. They were wrong. Spreads on high yield actually contracted in 2019 and currently sit as levels not seen since before the Great Recession. The only segment of the non-Investment Grade bond market that is under pressure today is the highly speculative CCC-rating, where spreads are widening in anticipation of higher default rates. The high yield market remains vulnerable if a loss of confidence in the economy occurs, but until then it is just whistling walking past the graveyard.

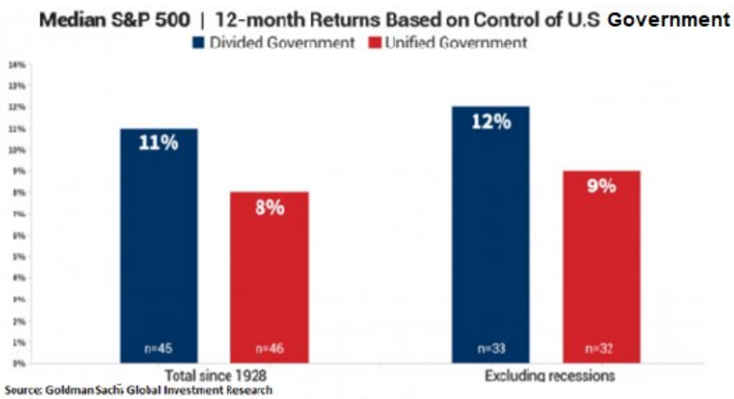
Taking Stock – Mega Cap Madness

The five top holdings in the S&P 500 (AAPL, MSFT, GOOGL, FB, AMZN) now make up nearly 17% of the S&P 500 as of December 2019 (S&P Dow Jones). The last December the S&P 500 was this top heavy was 1999. Apple, Microsoft and Facebook have dramatically outpaced the S&P 500 in 2019 performance. Furthermore, technology makes up over 20% of the index. In 1999, tech made up 29% of the S&P 500. According to Yardeni Research, S&P 500 forward P/E as of December 12, 2019 is approximately 18. Forward P/E ex-FAANGM is just above 16. FAANGM includes Facebook, Amazon, Apple, Netflix, Google, and Microsoft. For the same time period, forward price to sales for the S&P 500 was 2.2, while S&P 500 ex FANG was about 2.0 (Yardeni Research). Investors may be wise to consider alternatives to market cap weighting that result in overweighting over valued securities.



Technical - United We Fail?

With so much focus on politics and the 2020 election, it is interesting to see how the market has performed during different political environments. The market has performed slightly better during Democrat administrations compared to Republican, although many would suggest that has more to do with the economy than a particular party's policies. What makes more intuitive sense, however, is the outperformance of the markets when government is divided and neither party controls both chambers of Congress and the White House. Investors are distrusting of either party being in full control of the government regardless of political leaning. Stock market returns may be significantly impacted in 2020 and 2021 depending on what happens this Fall. Polling today suggests the House is likely to remain under Democratic control and the Senate under Republican control with the White House a toss-up, so no worry about control at this point.



Suggested Reading for the New Year

Clint Pekrul, CFA

To start the new year, we thought it would be interesting to provide suggested reading for our clients. What follows is a list, albeit short, of book reviews that pertain to finance and investment, and other topics we find worthwhile. We've categorized the books as either technical (i.e. the content gets into the weeds a bit) or general (i.e. the content is suited for a broader audience). Enjoy!

The Maxims of Wall Street, by Mark Skousen, 2013
Category - General

A mix of wisdom and humor, this book's roughly 200 pages is filled with pithy quotes delivered down from the past century from some of the industry's prominent leaders. "Bears Make Headlines, Bulls Make Money – A compendium of financial adages, ancient proverbs, and worldly wisdom" is the fitting subtitle. The book is full of insightful quotes:

A 50% loss requires a 100% gain to break even
It's better to be approximately right than precisely wrong
Better to prepare than to predict
We can't direct the wind, but we can adjust the sail
The man who's a bear on the U.S. will eventually go broke

Against the Gods: The Remarkable Story of Risk, by Peter Bernstein, 1996
Category – Technical

We say it's technical, but Against the Gods is not necessarily overly abstract. Bernstein does a remarkable job of mapping the history of our understanding of risk. Thousands of years ago (think ancient Greece), astronomers had mapped the skies and mathematicians had mastered geometry. Yet, as inconceivable as it might seem today, there was no concept of risk. The future path of events was at the whim of the gods, and oracles and soothsayers were endowed with magical crystal balls.

There was no consideration at the time that we could predict what might happen in the future and make choices today based on those predictions. There was no construct to guide the decision-making process that might lead to better outcomes based on information known today. It wasn't until the Renaissance when mathematicians developed fields such as probability.

Bernstein walks the reader through history, from the time of crystal balls to the development of chaos theory. The story is quite amazing.

When Genius Failed: The Rise and Fall of Long-Term Capital Management, by Roger Lowenstein, 2000
Category: Technical

This book is fairly technical, as it tells the story of a failed hedge fund in the go-go 1990s. It's a story of hubris gone horribly wrong. Long-Term Capital Management (LTCM) was a firm run by a group of highly talented investment professionals. Two of the principals were Nobel Laureates. The investment strategy was based on their academic research that the securities markets are perfectly rational and prices followed certain patterns. One of the principals, Myron Scholes, actually developed a formula for pricing options contracts.

The reader can gloss over much of the technical aspects of this book to get to the real point of the story: the markets can make even the smartest professionals look foolish. LTCM delivered stellar returns for much of its existence, and the heavy movers on Wall Street wanted a piece of the action. The principals at LTCM were aloof, even cocky in their belief that they ran an infallible hedge fund, and only the select few could participate in their success.

LTCM's fortunes changed quickly in 1998, when Russia defaulted on its debt obligations. LTCM had placed leveraged bets that quickly (in a matter of days) wiped out billions. The principals went from heroes to pariahs. The fund needed a bailout to avoid a market panic. Interestingly, the events of LTCM occurred almost 10 years before the financial crisis of 2008.

1929 The Great Crash: by John Kenneth Galbraith, 1997 (originally published in 1955)
Category: General

The book's introduction in the 1997 release is telling. Galbraith's story has been in print since 1955, but still remains in circulation. Why? Just when the book begins to recede into a distant memory, another episode (today, we call them "market disruption events") occurs to bring The Great Crash back into the public's conscience.

To quote the author in 1997, "there is now far more money flowing into the stock market than there is intelligence to guide it". Of course, we all now how the exuberance of the 1990s ended. The benchmark S&P 500 lost roughly half its value from 2000-2002. The author died in 2006, just ahead of the financial crisis of 2008.

While the details and timeline might change, the causes and effects of market bubbles really doesn't change. History might not repeat itself, but it sure does rhyme. The chapters of Galbraith's book begin with visions of boundless hope and optimism, to the twilight of illusion, to the aftermath, and finally cause and consequence.

Galbraith's story reads much like the more recent chronicles of the 2008-2009 great recession. Seems like some things never change.

Q: Will current deficits lead to an inflation tsunami?

Under the traditional framework for economics that ruled the world for centuries, you would have to say yes. When countries get overextended with debt it has several repercussions. Growth is stalled in the economy because an increasing amount of national capital is allocated for debt service and not used on more productive uses. Excessive debt levels also result in a lower level of confidence in the debt-ridden economy, causing their currency to lose value with respect to competing currencies. A vicious cycle ensues where growth slows and currency weakens until a country is forced to either default on their debt or print money to pay their bills. At this point inflation becomes uncontrollable and the economy is ravaged in a "normal" world.

We have not lived in a normal world, however, since coming out of the financial crisis of 2008. Debt levels no longer matter if a country's Central Bank is willing to monetize the debt by purchasing an unlimited amount of new sovereign debt issued. As long as the Central Bank can maintain credibility the charade can last an indefinite amount of time. I am of the camp that economic fundamentals can be delayed for extended periods but the laws of economics cannot be repealed. If country running large fiscal deficits does not make changes, the negative effects of over indebtedness will surface with a vengeance.

That's a timely question, given that the deficit has swelled from roughly $650 billion in 2017, the year president Trump took office, to approximately $980 billion today. That's a jump of about 50%. Former Fed chairman Alan Greenspan spoke recently that the ballooning deficits will ultimately lead to inflation. As excess dollars float through the system, overall price levels will tend to rise. This view suggests there is a direct link between burgeoning deficits and resulting inflation. We generally understand what policy action the Fed would take to tame inflation – an increase in policy interest rates. As we saw in 2018, even the prospect of higher interest rates is very disruptive, and tends to rattle investor confidence.

We've been talking about higher inflation and higher interest rates for over a decade now. First, the narrative was that with all the quantitative easing (i.e. money printing) that followed the credit crisis, inflation was sure to follow. Expanding the currency base would push prices higher. However, this didn't happen. Banks did not loan out the money and the money supply didn't flood the market (i.e. no inflation). Now the narrative is that with record deficits (as a percentage of GDP), we're sure to trigger inflation. But it depends on how we finance these deficits. If there is global demand for Treasuries, as there is today, then the government can keep financing by issuing debt securities. I think the biggest risk for inflation is if for some reason markets perceive a deterioration in the credit risk of U.S. debt securities. In that case the demand for U.S. treasuries will wane, and rates will rise. To combat this, the Fed might be forced to print our way out (i.e. basically make worthless money). Then we will have an inflation problem.

Q: Does the Torry majority make you bullish on the UK?

Yes, after a period of adjustment that could take up to 2 years I do believe the UK economy will achieve growth levels not seen in the last couple of decades. There is little doubt that the uncertainty about Brexit, passed by the voters but refused to be implemented by the politicians, was harmful to the economy. Whether in hindsight it proves to be a smart thing to leave the EU or not, getting rid of the uncertainty and political drama of the decision will be beneficial and people can more effectively move forward.

The flip side of the same coin could make the argument that Brexit being completed is very bad for the EU in general. I believe the reason Brussels resisted and made the break-up so difficult is because if the UK can demonstrate the ability to leave the EU without all the threatened repercussions, it will become a model for other nations to follow. Like the Prime Minister or not, Boris Johnson has shown a willingness to expend political capital to do what he believes is best for Britain. There will no doubt be mistakes made along the way, but seeing a political leader with the courage to take bold action is refreshing and is likely to bring a high degree of prosperity to the UK. I expect to see the Pound gain and the London Stock Exchange advance in 2020.

The Conservatives just achieved a landslide victory over Labour with Boris Johnson at the helm. I believe the results give the Conservatives their largest majority since Margaret Thatcher led the party back in 1987, while Labour faced its worst defeat since the 1930s. The election results pretty much ensure that Brexit will get done. So, what does a post Brexit look like and should we be bullish about the future?

Boris Johnson and his party's mantra is low taxes and less regulation. Under the EU's umbrella, the UK was prevented from implementing plans such as exempting imports from tariffs and creating enterprise zones for investment. The expectation now is that in a post Brexit world, the UK will no longer be burdened with the red tape and bureaucracy from the EU. On the surface, this seems like a reason to be bullish. The UK's economy will likely benefit in the long run. At any rate, this will give economists a case study of a pre- and post-EU economy.

All weights as of January 1, 2020

Income	
Mortgage Backed Bond	45.54%
Investment Grade Credit	13.26%
High Yield Bonds	13.56%
Preferred Stock	14.22%
US Dividend Equities	5.62%
US REITs	7.78%

Balanced Income	
US Dividend Equities	15.30%
International Dividend Equities	18.79%
US REITs	15.75%
High Yield Bonds	31.31%
Long Term Treasuries	18.85%

US Growth	
Low Volatility Factor	16.05%
High Quality Factor	12.86%
Small Cap Factor	13.74%
Value Factor	14.90%
Momentum Factor	11.44%
Long Term Treasuries	30.99%

Global Growth	
Low Volatility Factor	8.53%
High Quality Factor	6.22%
Small Cap Factor	7.21%
Value Factor	7.28%
Momentum Factor	5.36%
Developed Market Equity	20.83%
Emerging Market Equity	16.87%
Long Term Treasuries	27.70%

Weights are approximations only and subject to change.

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